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Dynamics of East Asian regionalism, what implications for the EU?

By Jappe Eckhardt

East Asia is one of the fastest growing and most dynamic regions in the world and has become an increasingly influential player on the international stage. At the moment the region is going through historic economic and geopolitical changes that will have important implications for the world economic landscape. One of the most dramatic changes has been the economic slowdown of Japan since the end of the 1980s. Japan, the country of the economic miracle, the undisputed economic leader of the region, suddenly fell from his pedestal. Although there are signs that the Japanese economy is back on the right track, it is highly questionable whether Japan is capable of regaining its dominant position as the region's economic leader. All the more since, during Japan's slowdown, China's economy grew with a breathtaking speed and is now seen as a challenge to Japan's leadership. But the question is whether China will be able to sustain this high growth and, if so, indeed (as some say) overtake Japan as the regional economic leader in the near future? Paradoxically, another important development in East Asia is the growing economic interdependence between China and Japan. In the last five years the Sino-Japan bilateral trade volume has been growing with approximately 30 percent per year to almost 130 billion dollars a year in 2003. This growing warmth in the economic relationship between Japan and China, some say, can be the overture for closer integration within the region. As stated above all these changes not only have important implications for the region but also for the world at large. What are the specific implications for the EU? And how should the EU respond to the dynamics in East Asia?

China's rise? Japan's decline?

If the amount of media attention were the only indicator for economic leadership, China would definitely have overtaken Japan by now. Every newspaper and news channel is reporting on the China success story extensively and all business magazines tell the world about the golden investment opportunities. According to most mass media there is no doubt: China will be the new

economic leader of East Asia. A scenario feared by many in Japan. But will China indeed outstrip Japan in the near future? There is no doubt about the fact that the Chinese economic rise, in terms of speed and scale, has been remarkable. In the twenty-five years since Deng Xiaoping opened the country to market forces China has managed to become one of the most powerful forces in the global economy. It has attracted hundreds of billions of dollars of foreign direct investments and has become one of the most important centres of world manufacturing. It has in fact outstripped Japan as market leader in many electronic products. Production of products such as DVD-players, mobile phones, air conditioner's and desktop PC's used to be more or less monopolised by Japan. Today China is the main producer of all of them. Although Japan is still the leader in the world-wide production of notebook PC's, LCD displays and digital camera's it is expected that China will surpass Japan in these items as well. China has already overtaken Japan as the country with the largest trade surplus with the US.

Besides its increasing leading role in manufacturing production, China is also actively taking the lead in changing the regional landscape. China's economic rise has contributed much more than Japan to the growth of intra-regional trade. China is very active in promoting regional frameworks, especially Free Trade Agreements (FTA's), to stimulate regional integration. Whereas Japan was the first to introduce FTA's in the region, China is now definitely leading the process. In 2002, for example, China and ASEAN signed the Framework Agreement on ASEAN-China Economic Co-operation that should lead to a free trade area by 2010 (2015 for new ASEAN members). Regarding FTA's Japan has been, according to the Japan External Trade Organization (JETRO), 'slow off the blocks compared with China, and such slowness could not only imperil its successes to date but also derail efforts to revitalize the Japanese economy.'

China's GDP tripled between 1990 and 2000 and it continues to grow fast. Indeed, if it continues to grow at its current high

rate (around 8% per year), and Japan's economy will grow 'only' 2,5 % a year, China's GDP will outstrip that of Japan between 2025 and 2030 (see table).

state enterprises it is not clear how the Chinese government will cope with the large number of unemployed workers resulting from this restructuring.

Projected US\$GDP		
2004\$USbn	China (growth 8% annual)	Japan (growth 2,5% annual)
2005	1512	4305
2010	2222	4871
2015	3264	5511
2020	4796	6235
2025	7047	7054
2030	10355	7981

Source: World Bank (2004)

Small wonder that China is in the centre of the world's attention, but the China fans and China phobes should keep a few important facts in mind. First of all, development indicators show that China is now at the same development level as Japan around 1960. Today, China's life expectancy at birth, its infant mortality rate, primary sector as a percentage of GDP, electricity consumption per capita, etc. are similar to Japan's about forty years ago. In addition, China may be one of the fastest growing economies in the world, yet its trade volume is 35 % smaller than Japan's and its GDP is still only 30 per cent of the size of Japan's. China's population is 10 times that of Japan, and hence its GDP per capita, adjusted for the purchasing power parity, is quite small in comparison to Japan's. The World Bank's GDP per capita global ranking (PPP) puts Japan as 18th with \$28.000, while China's with \$5.000 ranks 122nd.

Furthermore China faces problems that make Japan's problems look like a trifle. Most of China's problems are in one way or the other linked to the difficult transition from communist structures to free market structures. There is, for example, still a major lack of transparency in many aspects of the business environment and corruption is widespread in all layers of the Chinese society. In Transparency International's latest Corruption Perceptions Index, for example, China ranks the 71st among the 146 countries, with a score of 3,4 out of 10, indicating its corruption has remained very serious.

Besides that, the financial and fiscal systems are very unstable. According to The Economist 'the country's banks have buried themselves under an avalanche of bad loans and this could threaten a collapse of China's entire financial system. Today, some independent estimates put the level of bad loans at around \$420 billion, or nearly 40% of gross domestic product.' The biggest problem is that state controlled banks allocate nearly 90 percent of the total credits and give a preferential treatment to state firms when it comes to loans. This continued use of its banks as cash machines for its unprofitable state owned enterprises is, as The Economist states, 'a big drag on China's rapid economic growth, and may well end up imperilling it.'

State owned enterprises also get preferential consideration for listing on China's stock markets and are awarded with government contracts much more often than private companies. According to Toshio Watanabe, a leading Japanese scholar, China cannot develop into an advanced economy without restructuring these state enterprises.' State enterprises hold more than 50% of the fixed assets of the industrial sector and provide more than 40% of the employment in urban areas.' Even if China restructures the many inefficient

Then there are the growing social and regional disparities, especially between the cities and the countryside. Unemployment is rapidly increasing in rural areas and if you are lucky enough to keep your job, wages lag far behind those in urban areas. In fact, a recent study by the Chinese Academy of Social Sciences has concluded that China's urban-rural income gap has become one of the worst in the world, only slightly narrower than Zimbabwe's. To cope with this problem the government must find ways to create 15 million new jobs a year. One solution is to move half of the people living in the rural areas into the cities. But this is easier said than done. At present two third of the Chinese live in the countryside, moving half of them means 400 million new people in the already plagued Chinese cities. Because China does not have enough resources to build all the new roads, houses and schools that are necessary, the country must import huge amounts of cement, iron and other building material.

This brings up another aspect to keep in mind when analysing the Chinese success story. China is more and more dependent on foreign companies and investors for imports of its resources, its industrial production and for its exports. Today over 40 percent of China's industrial production and more than half of its manufacturing exports originate from foreign companies. In the case of high tech industries the FDI shares are 50 percent in the information industry and 70 percent in communication related production. This is extremely high for a large country like China. In fact, in a host of important sectors - from consumer electronics to retailing - wholly owned foreign invested enterprises are the norm. Thus for many products 'made in China', the value added that is truly Chinese is only a small part of its price.

In view of this, it is not sure at all that China is able to sustain its high growth rate and indeed overtake Japan between 2025 and 2030. But even if China surpasses Japan in terms of GDP within 25 years it will probably take very long, if it ever happens, before China overtakes Japan on its overall development level. Decades will go by before China's economy is as mature and stable as Japan's economy. To achieve this, the Chinese government has to take many necessary internal measures to overcome the problems mentioned above, while it remains also highly dependent on other countries for continuous economic growth. Paradoxically, Japan will play a crucial role in Chinese future economic success. At the same time, according to JETRO, Japanese firms have to, in order to break out of the negative economic spiral, expand its production networks in the region to maintain its leading position. 'This means producing and

procuring parts and materials from the most advantageous locations in the region, especially China.'

China and Japan's economic interdependence

China and Japan are increasingly important economic partners to each other. Since 2000, for example, the total trade between China and Japan increased with more than 30 percent per year. Although the US still is Japan's most imported export target, exports to the US are falling since 2000 while exports to China, now Japan's second export target, have been growing strongly in the last five years. The view, expressed by JETRO in 2003, that 'China drives Japanese trade recovery' is now spreading in Japan. According to the Japanese Ministry of Economy, many sectors are flourishing with demand from China and 'this is helping to prop up Japan's economic turnaround'. Furthermore in 2002 China overtook the US as Japan's biggest source of imports and now accounts for almost 25 percent of Japanese imports. So China's exports to Japan are growing very fast as well and are now China's second largest, while Japan's imports are its largest. Japan is now accounting for more than 15% of China's total foreign trade.

Close economic relations are not confined to trade alone. Investment, especially from Japan to China, contributes a lot as well to economic interdependence between both countries. In the first seven months of 2004, for example, new Japanese investment contracts in China rose 40 percent over the same period in the preceding year. This is partly due to the fact that Japanese businesses launched a new surge of investment in China, covering almost 28000 projects. The profitability of those investments has started to improve significantly, so more investments are bound to follow. In addition, although Japan has announced to decrease the amount of ODA to China, Japan's ODA still extends over half of the loans China receives from foreign governments. Japan has grown to be a very important source of technology and FDI for China. Investment in the opposite direction, from China to Japan, is still rare, however, some Chinese enterprises have gained commercial presence in the Japanese market and their performances are so far exceeding the expectations.

The economic links between China and Japan are also intensifying through partnerships between Japanese and Chinese businesses. Local Chinese companies are actively seeking business co-operation with their counterparts from Japan and a growing number of Chinese enterprises become interested in investing in Japanese companies, especially for the technology and distribution channels. In fact, last year a Chinese pharmaceutical company bought a Japanese manufacturer, a unique event because it was the first time a Chinese company purchased a Japanese one. There are, however, several bumps on the road of the Sino-Japan trade and economic relationship, some of which stem from the increased competition between the two countries. For example, the competition in trade, FDI and FTA's in the region has caused - and will continue to cause - trade frictions. After all, not all companies in Japan can seize the opportunity that the rise of China offers and in sectors that compete with China there will be more bankruptcies and higher unemployment. This, in turn, triggers demands for restrictive measures. Recently Japan temporarily prohibited trade with China in certain agricultural products, such as leeks and spinach, and other Chinese products, including towels. The Chinese government responded by levying prohibitive tariffs on automobile, mobile phone and air-conditioning products from Japan. Although it is widely believed that this competition - and thus economic friction - between Japan and China will intensify in the future all of this has to be put into perspective. Frictions are normal in trade ties between two economic giants, with trade volumes of hun-

dreds of billions of dollars a year. The growing economic competition between Japan and China can be very healthy, it will keep both countries sharp and act as a stimulus for reforms on both sides.

However, competition is only one side of the story, the other side is the fact that China and Japan are playing complementary roles. The closer two countries are in their level of economic development, the more likely they are to be competing, while the wider the gap the more likely they are to complement each other. RIETI estimates, for example, show that China and Japan compete for only 20% of their exports to the United States. The same can be said for FDI's. A high-income country, like Japan, rich in funds and technology is likely to benefit from China's investment attractiveness more than it is hurt by it. The high returns Japan get by investing in China are bigger than the losses (from investment going to China instead of to Japan). Whereas lower-income countries, that compete with China for foreign capital are more likely to suffer because of a diversion of investment funds to China. Thus, on the economic side, despite some frictions, the future of China - Japan relations looks bright. Trade is flourishing, there is a fast growing interdependence and it seems that the two economies complement each other.

This growing warmth in the economic relationship between Japan and China, some say, can be the overture for closer integration within in the region. This, because the difficulties in Sino-Japanese ties have always been seen as one of the obstacles towards building regional institutions. So there is indeed a momentum for taking the next step. But this will only happen if this positive attitude spills over to the political level, because that is after all where the decisions, regarding regional integration, are made. So far however the relationship on the political side between Japan and China is often described as cold. The individual businesses are the actors responsible for the warmth in the economic arena not the governments, they have contributed virtually nothing to this development. There have been some political attempts towards closer relations, like the establishment of the 21st century Committee for Japan-China Friendship - a committee of Japanese and Chinese businessmen and government officials. In addition there was the China - Japan summit, that took place in May 2003 in St. Petersburg, where Hu and Koizumi emphasized the 'close friendship between China and Japan'. But this summit only lasted for 45 minutes and, despite some positive promises, no real action has been taken since to improve political ties.

One of the most important obstacles towards a closer political relationship is the history. 'As long as Koizumi is continuing the controversial practice of making visits to Yasukuni Shrine', where Japanese war criminals are among the wartime dead enshrined, a friendly relationship is extremely difficult, Chinese officials say. The Japanese on the other hand have begun to feel that, even if Koizumi stops his visits to the shrine, no amount of apologies will ever satisfy the Chinese. These developments keep on causing nationalistic sentiments in both countries, sentiments which are further fed by the fact that the Japanese government and ordinary Japanese are still not used to a lower relative position for Japan's economic size in the region and the growing confidence on the Chinese side. While in China there is the feeling that Japan is focusing too much on the United States.

For a closer relationship to materialize, first of all, a constructive dialogue on historical issues is necessary. Furthermore the Japanese have to start realizing that trade and direct investment are by no means zero-sum games, it is possible for all economies in the region to benefit from China's success. Just as China has to realize that they need Japan to sustain its economic growth. Corporate Japan and

China have spotted this potential, now it is time for its people, its political leaders and bureaucratic masters to follow.

Implications for the EU

East Asia is going through historic economic and geopolitical changes. The rise of China, the relative declining in Japan's power, growing interdependence between China and Japan and, possibly, closer regional integration are changing the economic and political landscape in East Asia. All of this has important implications for EU's role in the region. There are two possible scenarios.

The first, is the doom scenario in which East Asia will be a threat to the EU. If the closer relationship between Japan and China indeed lead to actual regional integration, East Asia will overtake the EU as second political and economic power in the world, affecting EU's position in numerous intergovernmental organizations. Closer integration in the region might, in addition, lead to a 'fortress Asia', a development that will have severe consequences for EU's trade to the region. But even without building 'a fortress' an increasing strong growth in trade between Japan and China might affect EU trade towards the region, because of a decrease in the demand for European imports in Japan, China and maybe even in the whole region. The EU is, after all, increasingly competing with Japan for trade towards China and China itself will also become an important economic rival in the near future.

On the other hand, the EU can also benefit from closer China- Japan economic relations and, possible, closer regional integration. Economic integration will engage the countries in the region in stable interdependence where the prosperity of one country is in the interest of others and make them more predictable and reliable to each other and the rest of the world. More stability in turn will cause further economic growth and might lead to growing demand for European products and investment. Stability will, furthermore, increase the profitability of investments, making the region a good and, above all, lucrative investment destination for the EU.

It is unsure which of these scenarios is the most likely, therefore further research is necessary. But one thing is sure, the EU should act quickly because so far the EU has not paid enough attention to the relationship between Japan and China and its possible consequences. So far, the EU developed two separate bilateral strategies towards Japan and China and one Asia strategy, which only focuses on non-OECD countries. What the EU needs is an integrated East Asia strategy, including OECD and non-OECD countries, with in the center of its analyses the Sino-Japanese relations because this will increasingly shape the future of East Asia's regional landscape.

A note on the Author

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